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IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

O'MELVENY & MYERS,
A LAW PARTNERSHIP,
v. *Petitioner,*

FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER
FOR AMERICAN DIVERSIFIED SAVINGS BANK, ADC FI-
NANCIAL CORPORATION, AMERICAN DIVERSIFIED/WELLS
PARK II, and AMERICAN DIVERSIFIED/GATEWAY CENTER,
Respondents.

On Writ of Certiorari to the
United States Court of Appeals
for the Ninth Circuit

**BRIEF AMICI CURIAE OF ARTHUR ANDERSEN & CO.,
COOPERS & LYBRAND, DELOITTE & TOUCHE,
ERNST & YOUNG, KPMG PEAT MARWICK, AND
PRICE WATERHOUSE IN SUPPORT OF PETITIONER**

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QUESTIONS PRESENTED

1. Whether the court of appeals erred by failing to incorporate state law as the federal rule of decision in determining whether the FDIC as receiver for a failed financial institution is entitled to recover under a cause of action for professional negligence that would have been defective if brought by the institution itself prior to receivership.

2. Whether the court of appeals erred by failing to incorporate state law as the federal rule of decision in determining whether the knowledge of a corporation's 100% shareholders and management should be attributed to the corporate entity.

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INTEREST OF THE AMICI CURIAE

With the consent of the parties pursuant to Rule 37 of the Rules of this Court, *amici curiae* submit this brief in support of petitioner O'Melveny & Myers ("O'Melveny"). *Amici curiae* are major professional service firms engaged in the practice of accounting and auditing. They are the six largest firms practicing this profession in the

United States, reporting, collectively, on the financial statements of more than 90% of those companies whose securities are publicly traded in the United States. Of particular relevance to this case, *amici curiae* serve as independent auditors for approximately 80% of the depository institutions or their parent corporations that are publicly traded in the United States. See *Who Audits America* 1-427 (Spencer Phelps Harris ed., 28th ed. 1992). Consequently, *amici curiae* are directly affected by the legal rights and obligations applicable to professionals who provide services to depository institutions and have a vital interest in the sound development of the law in this area.

The decision below greatly expands the powers of federal banking agencies when they act as receiver of a failed depository institution and as successor in interest assert negligence claims against the institution's outside professionals. Until the Ninth Circuit's decision, such claims generally have been governed by state law, which permits a variety of defenses based on the knowledge and conduct of a corporate client's officers, directors, and shareholders. The court of appeals, however, created two federal rules of decision, each of which grants the FDIC what is essentially a blanket exemption from such defenses. The court of appeals thereby created professional negligence liability under federal common law where none would have existed under state law.

The extent of an outside professional's liability for negligence is an issue that has been raised repeatedly in cases arising out of the savings and loan crisis of the 1980's. The issue is important not just for disposing of cases relating to depository institutions that already have failed, but also for the future. It is impossible to erect a wall between a professional's pre-receivership relationship with its client and the professional's post-receivership liability arising out of that relationship. Judicial expansion of a professional's exposure to post-insolvency negli-

gence liability not only will affect the cost at which professional services can be provided to ongoing institutions, but also the nature of such services and the manner in which they are provided.

Balancing competing policy considerations is peculiarly a legislative function. In 1989, after considering the views of both the banking agencies and the various professions, including the accounting profession, Congress provided regulators with a new administrative remedy against outside professionals that was designed to preserve the regulatory objectives of federal banking law. Yet this statutory remedy imposes liability only for serious misconduct and not for the mere negligence alleged in this case. See page 9, *infra*. The decision below, if allowed to stand, will upset this recent congressional policy determination and will impair the ability of *amici curiae* to provide quality and cost-effective services to their many depository institution clients.

STATEMENT OF THE CASE

The FDIC brought this action as receiver of American Diversified Savings Bank ("ADSB"), a failed savings and loan association, and, therefore, as a "former client[]" of O'Melveny. FDIC Opening Brief in C.A. No. 90-55769 at 1. The FDIC sought to recover from O'Melveny for failing to exercise due care in preparing offering memoranda for two real estate limited partnership offerings sponsored by ADSB affiliates. In particular, the FDIC alleged that O'Melveny negligently failed to discover and disclose that ADSB was in poor financial condition. O'Melveny responded by arguing that the officers who dominated and controlled ADSB's affairs and owned 100% of its stock, Ranbir Sahni and Lester Day, were well aware of and had deliberately concealed ADSB's true financial condition. Accordingly, O'Melveny contended that it could not be liable to its client for failing to discover and disclose that which the client already knew and

was concealing. The district court granted summary judgment to O'Melveny, but the court of appeals reversed. It held that O'Melveny owed ADSB a duty to investigate the truthfulness of the representations of ADSB's senior management, that the knowledge of Sahni and Day should not be imputed to ADSB, and that the FDIC as receiver was not subject to defenses based on the knowledge of Sahni and Day, even if those defenses would have been good against ADSB prior to receivership. Pet. App. 6a-15a.

SUMMARY OF ARGUMENT

It appears to have become "conventional wisdom" that outside professionals should be held substantially responsible for losses resulting from the extraordinary number of savings and loan associations that failed during the 1980's. *Amici curiae* submit, however, that the proper function of the federal judiciary is to ignore the untested generalities of "conventional wisdom" and instead to dispose of individual cases through disciplined application of established legal principles. If professionals are found liable in these circumstances, so be it.

It is entirely another matter when, as in this case, professionals would have no liability under settled principles of state law, yet federal courts simply discard these principles, create federal rules of decision, and impose liability based solely on their ad hoc policy views. It is particularly disturbing when the only policy identified is increasing the "asset pool" available to the federal banking agencies. Pet. App. 15a. Liability thus becomes an end in itself rather than the result of a neutral, judicial process. In these circumstances, the untested "conventional wisdom" that professionals are responsible for losses to the deposit insurance system is turned into a self-fulfilling prophecy simply by the tour de force of changing the rules after the game is over.

The decision below raises a fundamental issue of federal jurisprudence—whether the judiciary is free to fash-

ion federal rules of decision favoring the federal banking agencies when they assert what otherwise would be traditional state law causes of action as receivers of failed depository institutions. The court of appeals answered this question affirmatively and created two federal rules of decision. The effect of each of these rules was to preclude O'Melveny from asserting a defense based on the knowledge of its client's officers, directors, and 100% shareholders, even though the defense would have required dismissal of the action under state law.

Whatever may be the merits of the Ninth Circuit's concern for the FDIC's asset pool, it surely is not the judiciary's function to give this policy the force of law in the absence of any direction from Congress. Indeed, the decision below is perhaps most striking for the court's failure even to attempt to identify statutory support for its policy views. In case after case arising out of financial institution failures, the FDIC and other banking agencies have requested courts to discard established state law legal principles in favor of federal rules based on the agencies' view of federal policy. The Court should affirm that the federal judiciary's function in such litigation is not to legislate new causes of action, but to apply established legal principles in an objective and disciplined manner. The judgment of the court of appeals should be reversed.

ARGUMENT

I. THERE IS NO NEED FOR THE FEDERAL COURTS TO FASHION A UNIFORM FEDERAL RULE GOVERNING WHETHER THE FDIC, ACTING AS RECEIVER FOR A FAILED DEPOSITORY INSTITUTION, IS SUBJECT TO DEFENSES BASED ON THE KNOWLEDGE OF THE INSTITUTION'S OWNERS AND MANAGEMENT

The entire opinion of the court of appeals was informed by its policy view that the FDIC should not be disadvantaged by the actions of those who owned and controlled the institution it represents as a receiver. *See, e.g.,* Pet. App. 10a (rejecting O'Melveny's defense "particularly in view of the public expectation that the wrongdoing [of corporate insiders] will be exposed, the wrongdoers pursued, and the innocent victims of fraud will have a chance at recovering"). Moreover, the court believed it was free to reject state law and fashion federal common law to effectuate this policy view. Pet. App. 13a-14a ("It is by now clear beyond doubt that federal, not state, law governs the application of defenses against FDIC. While we may incorporate state law to provide the federal rule of decision, we are not bound to do so.") (footnote omitted).

The court of appeals was mistaken. For the reasons fully discussed in the Brief For Petitioner, the statutory scheme enacted by Congress defining the rights of the FDIC as receiver leaves no room for the federal courts to create federal rules of decision expanding those rights. Moreover, even when a federal rule of decision is required, federal courts should incorporate state law as the federal rule of decision except when the federal "scheme in question evidences a distinct need for nationwide legal standards," "express provisions in analogous statutory schemes embody congressional policy choices readily applicable to the matter at hand," or application of state law "would frustrate specific objectives of the federal

programs." *Kamen v. Kemper Financial Services, Inc.*, 111 S. Ct. 1711, 1717 (1991) (citations and quotation marks omitted). None of these exceptions is applicable in this case.

A. Congress Itself Has Rejected Uniformity By Incorporating State Law In Statutes Specifying The Rights Of The FDIC As Receiver

Beginning with enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 ("FIRREA") (codified in scattered sections of Title 12), Congress has comprehensively addressed the issue of how to reform the federal regulatory scheme applicable to failed financial institutions and, where Congress considered it appropriate, has modified state law principles. For example, Congress has specifically overridden state law in certain limited respects by not requiring the FDIC to prove any more than gross negligence in receivership actions against officers and directors, 12 U.S.C. § 1821(k), and by imposing minimum limitations periods. 12 U.S.C. § 1821(d)(14).

Congress has not, however, expressed dissatisfaction with the principle that state law generally should provide the rule of decision on most issues. Indeed, even when Congress has found it appropriate to modify state law in some respect, Congress also has expressed its willingness otherwise to defer to state law. For example, FIRREA provides that directors and officers of insured depository institutions may be liable for gross negligence and intentional tortious conduct, "*as such terms are defined and determined under applicable State law.*" 12 U.S.C. § 1821(k) (emphasis added). Ironically, the Ninth Circuit itself has recognized the absence of a need for uniformity in a decision issued only three months after the decision below. In rejecting an argument that Section 1821(k) established a uniform standard of liability for officers of depository institutions, the court noted that "[n]owhere does FIRREA indicate an aim to create na-

tional uniformity in liability standards.” FDIC v. McSweeney, 976 F.2d 532, 539 (9th Cir. 1992), *cert. denied*, 113 S. Ct. 2440 (1993) (emphasis added). In sum, the actions of Congress belie any argument that uniformity is required in actions brought by the FDIC as receiver for a failed depository institution.

B. Incorporation Of State Law Defenses To A Professional Negligence Cause Of Action Is Consistent With Federal Regulatory Policy

Perhaps the most significant flaw in the Ninth Circuit’s legal analysis was its misapprehension of the nature of the allegations against O’Melveny. The court apparently believed, albeit mistakenly, that O’Melveny somehow participated in the wrongdoing of the ADSB insiders. *See, e.g.*, Pet. App. 6a (“O’Melveny contends . . . that the [FDIC] is subject to all defenses that might lie as between the wrongdoers themselves and those who may have aided and abetted them in bringing about the disaster.”). The FDIC has never alleged, however, that O’Melveny colluded with the ADSB insiders in defrauding ADSB. To the contrary, the primary charge against O’Melveny is that it acted negligently (*i.e.*, in good faith but without due care) by *failing to discover* the wrongdoing of ADSB’s owners and management. Because it missed this critical distinction, the court of appeals mistakenly believed that incorporating state law would conflict with federal regulatory policy.

1. Congress Has Determined That Federal Regulatory Objectives Are Preserved If Outside Professionals Are Held Responsible For Serious Misconduct As Opposed To Mere Negligence

In FIRREA, Congress addressed the issue of what additional powers were needed by the federal banking agencies to regulate the conduct of outside professionals who provide services to insured depository institutions, no doubt in response to many of the same policy consid-

erations that motivated the court of appeals in this case. Although Congress authorized the banking agencies acting in their governmental (as opposed to receivership) capacity to assert an administrative remedy against outside professionals, it imposed liability only for knowing or reckless behavior, not for mere negligence, and thus the government could not have maintained an action against O’Melveny for negligence if it had brought suit in its governmental capacity. *See* 12 U.S.C. § 1813(u) (definition of “institution-affiliated party” encompasses an “independent contractor (including any attorney, appraiser, or accountant)” only if the independent contractor “knowingly or recklessly participates” in any violation of law, breach of fiduciary duty, or unsound practice); 12 U.S.C. § 1818(b)(6)(A) (granting banking agencies the authority to require an “institution-affiliated party” to make restitution or reimbursement against loss in connection with issuance of a cease and desist order). In making this determination, Congress was aware of the complex policy considerations involved and acted only after hearing the views of all parties (H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 466, *reprinted in* 1989 U.S.C.C.A.N. 86, 262):

Balancing legitimate concerns with enforcement needs. [FIRREA] places limitations on the banking agencies, so that they cannot utilize their enforcement authority over independent contractors for necessarily the same misconduct, abuse, or violations which can give rise to enforcement orders against officers, directors, and employees of financial institutions. Appraisers, accountants, and attorneys have participated in some of the serious misconduct in banks and thrift institutions and are defendants in numerous lawsuits brought by the FDIC and the FSLIC. However, the inclusion of these independent contractors has raised the concern of the American Institute of Certified Public Accountants, the American Bar Association’s Business Law Section, and other groups. The Committee believes that section

901 addresses those concerns. Accordingly, the Committee has limited the exposure of independent contractors to serious misconduct.

This policy determination of Congress will be overturned if the decision below is allowed to stand. The court of appeals, concerned only with protecting the FDIC's "asset pool," would allow the FDIC to recover in this case even though (1) the government could not recover under the administrative remedy specifically created by Congress to protect the deposit insurance system, and (2) the failed institution itself or its successor-in-interest could not have recovered under established principles of state law. Whatever one thinks of the merits of the Ninth Circuit's views of federal policy, the judiciary clearly is not the proper forum for these decisions to be made. *See Bush v. Lucas*, 462 U.S. 367, 388, 390 (1983) (in deciding whether "an elaborate remedial system that has been constructed step by step, with careful attention to conflicting policy considerations, should be augmented by the creation of a new federal remedy," the Court declined to "create a new substantive legal liability without legislative aid" because "Congress is in a better position to decide whether or not the public interest would be served by creating it").

2. State Law Does Not Shield Outside Professionals From Liability If They Collude With Insiders In Defrauding An Institution

It is important to recognize that if the FDIC had been able to allege (which it could not) that O'Melveny colluded with Sahni and Day in defrauding ADSB, their knowledge clearly could not have been imputed to ADSB. Under long-established state law principles, the knowledge of an agent will not be imputed to a principal, corporate or otherwise, if the agent and the third party are acting in collusion to defraud the principal. *See First Nat'l Bank v. Reed*, 244 P. 368, 371 (Cal. 1926) ("there is an exception to the general rule

imputing to the principal the knowledge of the agent, which exception is to the effect that, if the agent and the third party are acting in collusion to defraud the principal, the principal will not be held bound by the knowledge of the agent"); 3 William M. Fletcher, *Fletcher Cyclopedic of the Law of Private Corporations* § 804, at 54 (perm. ed. rev. vol. 1986) ("The rule imputing agents' knowledge to the principal is intended to protect those exercising good faith and not as a shield for unfair dealing.") (internal quotation marks omitted).

Thus, state law would have provided the FDIC, as receiver for ADSB, with a remedy for serious misconduct by an outside adviser that defrauded ADSB. In this respect, the state law rule is quite consistent with the statutory remedy enacted by Congress. The FDIC, however, could not allege this type of serious misconduct and therefore found it necessary to press the court of appeals to create federal common law in order to prevail. Because the court of appeals acceded to the FDIC's request rather than incorporating state law principles that were entirely consistent with federal regulatory policy, the judgment below must be reversed.

II. THE COURT OF APPEALS ERRED IN FASHIONING TWO FEDERAL RULES OF DECISION TO DEFEAT O'MELVENY'S STATE LAW DEFENSE

The court of appeals offered two rationales for its decision to reject O'Melveny's state law defense. Each of the rationales was based on a newly-created federal rule of decision that permitted the FDIC to assert ADSB's professional negligence cause of action against O'Melveny free of any state law defenses based on the conduct of ADSB's 100% owners and management. One rule achieved this result directly—the court of appeals simply held that it would be inequitable to allow such a defense to be asserted against the FDIC, regardless of whether the defense could have been asserted against ADSB prior

to receivership. Pet. App. 13a-15a. The second federal rule was more subtle and seemingly couched in terms of state law principles, but just as radical as the first rule in its actual departure from state law. The court adopted the FDIC's position that the knowledge of an agent of an insured depository institution cannot be imputed to the institution if the agent acted adversely to the interests of corporate outsiders, including particularly the federal government as deposit insurer. *Id.* at 10a-13a. The interests of outsiders thereby replaced the interests of shareholders, which would have been determinative under state law. As discussed next, the court of appeals erred by adopting these federal rules rather than incorporating state law.

A. In The Absence Of Statutory Authorization, The FDIC As Receiver Is Not Entitled To Recover On An Institution's Claim For Professional Negligence That Would Have Been Defective If Brought By The Institution Itself Prior To Receivership

Little need be said to demonstrate that the court of appeals impermissibly adopted a federal rule of decision in holding that the FDIC takes rights greater than those of the institution it represents as receiver. The court of appeals acknowledged that under California law a "receiver occupies no better position than that which was occupied by the . . . party for whom he acts . . . and any defense good against the original party is good against the receiver." Pet. App. 13a (alteration in original) (quoting *Allen v. Ramsay*, 179 Cal. App. 2d 843, 854 (1960)). Nevertheless, the Ninth Circuit rejected California law and fashioned its own federal rule of decision. See Pet. App. 13a ("The flaw in [O'Melveny's] argument is the law O'Melveny assumes applies. It is by now clear beyond doubt that federal, not state, law governs the application of defenses against FDIC."). Without attempting to ascertain congressional intent and guided only by "the age-old principle[] that equity does equity,"

the court concluded that "equitable defenses good against a bank do not carry over against the bank's receiver." *Id.* at 14a.

The Ninth Circuit believed the "intricate" federal statutory scheme for banking regulation would be frustrated if the FDIC were subject to defenses based on the wrongful conduct of the institution's owners and managers. See, e.g., Pet. App. 6a ("O'Melveny contends that the federal agency created by Congress to rescue the economy and the victims of failing thrifts can claim no stronger ethical position than did the wrongdoers within that corporate entity We find such a proposition incredible"). Despite the Ninth Circuit's disbelief, the principle that a depository institution's receiver stands in the shoes of the institution is not new, but rather is an established principle of general receivership law. See, e.g., *Coit Independence Joint Venture v. FSLIC*, 489 U.S. 561, 571 (1989) ("Once FSLIC is appointed receiver of an insolvent savings and loan association, FSLIC steps into the shoes of the association and takes control of its assets."); 2 Ralph E. Clark, *A Treatise on the Law and Practice of Receivers* § 362, at 619-620 (3d ed. 1959) ("The Supreme Court of the United States and federal authorities hold that the receiver of a bank stands in no better position than the bank stood as a going concern and when the bank was a party to an illegality, the court will leave the parties where it finds them by refusing relief to the receiver of such a bank.").

More importantly, Congress has not chosen to grant the FDIC the expanded powers that the Ninth Circuit provided by judicial fiat. Despite its general overhaul of the federal banking regulatory scheme with FIRREA, Congress has not expressed dissatisfaction with the general principle that the FDIC as receiver stands in the shoes of the institution. Indeed, the relevant federal statute does not enhance the FDIC's rights as receiver over those of the institution it represents, but provides that the

FDIC "shall, as conservator or receiver, and by operation of law, succeed to . . . all rights, titles, powers, and privileges of the insured depository institution . . ." 12 U.S.C. § 1821(d)(2)(A)(i). The legislative history of FIRREA notes that established rules of receivership law generally continue to apply in FDIC litigation. See H.R. Rep. No. 54(I) at 330, reprinted in 1989 U.S.C.C.A.N. at 126 ("[FIRREA] defines the FDIC's authorities and duties as conservator or receiver. The authorities essentially parallel those heretofore exercised by the FSLIC and the FDIC . . .").

It appears to have become the FDIC's standard litigation strategy to assert that state law principles should be disregarded because of an alleged federal "policy" of increasing the asset pool available to the federal government. Most courts have rebuffed the FDIC's efforts and instead have referred the agency to Congress. See, e.g., *FDIC v. Bowles Livestock Comm'n Co.*, 937 F.2d 1350, 1356 (8th Cir. 1991) ("Reduced to its essence this case asks only whether the FDIC may trump the ordinary operation of state laws. Precedent from this court cannot be as easily put aside as the FDIC would like, and instead mandates that the laws of Nebraska supply the substance of federal law."); *Sunbelt Sav., FSB Dallas, Tex. v. Montross*, 923 F.2d 353, 357 (5th Cir.) ("When the FDIC assumes control of an institution, the assets are what they are. . . . We agree that the FDIC should not be disadvantaged by the circumstances of its assumption of control, but this policy does not require giving the FDIC the ability to transmute lead into gold. . . . Alchemy is the province of Congress . . .") (emphasis added), reinstated on reh'g en banc, 944 F.2d 227 (5th Cir. 1991) (per curiam).¹ The court of appeals' failure

¹ See also *FDIC v. Ferguson*, 982 F.2d 404, 407-408 (10th Cir. 1991) ("The FDIC's stepping in [to a lawsuit filed by a failed institution] after nearly three years of litigation, asserting the taxpayers' loss as guarantor of insured deposits, does not transfer the case into the realm of the public interest."); *FDIC v. Jenkins*,

in this case to resist the temptation to effectuate its own policy preferences by creating federal common law requires reversal of the judgment below.

B. The Court Of Appeals Erred By Rejecting The State Law Rule That The Knowledge Of A Corporation's 100% Owners And Management Is Imputed To The Corporate Entity

The court of appeals began its analysis of whether the knowledge of Sahni and Day should be imputed to ADSB by reciting two unexceptional and undisputed principles of corporate law: (1) a corporation is a distinct legal entity separate from its stockholders and from its officers; and (2) the knowledge of a corporate officer acting within the scope of his or her employment is attributed to the corporation unless the officer was acting adversely to the corporation. Pet. App. 10a-11a.² The first prin-

888 F.2d 1537, 1544 (11th Cir. 1989) (the Supreme Court's "deference [in *Langley v. FDIC*, 484 U.S. 86 (1987)] to the legislation enacted by Congress . . . should serve as a guide for this Court in denying the FDIC's effort to create a priority which appears nowhere on the face of the Federal Deposit Insurance Act"); *FDIC v. Braemoor Assocs.*, 686 F.2d 550, 554 (7th Cir. 1982) ("The FDIC is suing as the assignee of the State Bank of Clearing's cause of action under state law against the defendants, and it is difficult to see why assignment to the FDIC should alter or enlarge that cause of action."), cert. denied, 461 U.S. 927 (1983).

² The court of appeals chose to address the issue whether Sahni and Day's knowledge should be imputed to ADSB solely in the context of whether O'Melveny could assert the equitable defense of estoppel. Imputation also is a general principle of corporate law that can affect many of the elements of a professional negligence cause of action, including reliance, causation, compliance with a statute of limitations, and contributory negligence. See, e.g., 3 Fletcher § 815, at 99 ("These general rules [of imputation] apply, of course, in a great variety of cases—in fact, in any case in which the question whether a corporation had notice of a particular fact is material. Thus, they apply when it is sought to charge the corporation with an officer's knowledge that a particular transaction was in fraud of third persons, . . . or to charge a corporation with notice of its own insolvency . . .") (footnotes omitted).

ciple is irrelevant in this case because imputing the knowledge of an agent to the corporate entity does not require "piercing the corporate veil" or proof that the agent was the "alter ego" of the corporate entity. Rather, the general rule, even accepting the separate existence of the corporate entity, is that an agent's knowledge will be imputed to the corporate entity because it is a legal fiction that can know and act only through its individual agents. See 3 Fletcher §787, at 12 ("[A] corporate body, as a legal entity, cannot itself have knowledge. If it can be said to have knowledge at all, that must be the imputed knowledge of some corporate agent. Knowledge of the proper corporate agent must be regarded, in legal effect, as the knowledge of the corporation.").

It was in applying the "adverse interest" exception to the general imputation rule that the court of appeals departed from state law and created a federal rule of decision. The court of appeals held that Sahni and Day had acted adversely to ADSB—the corporate entity that they totally owned and controlled. This holding is directly contrary to the straightforward state law rule that there can be no adverse interest between a corporation and its 100% owners and management.³ As a preeminent authority on corporate law has explained, "[w]here the officer to whom notice is given or by whom knowledge is acquired is in effect the corporation, the notice is generally imputed to the corporation. . . . So, the rule that a corporation is not charged with the knowledge of an officer acting adversely to it does not apply where an officer is also the sole stockholder" 3 Fletcher § 809, at 76-77 (emphasis added) (footnotes omitted). Indeed, the rules of imputation were developed in order to pre-

³ As fully discussed in the Brief For Petitioner, the court of appeals' holding also is contrary to the state law rule that the knowledge of an agent will be imputed when "the agent is in fact acting for his principal in the transaction, even though he may have an opposing personal interest." *McKenney v. Ellsworth*, 132 P. 75, 76 (Cal. 1913).

clude a corporation from claiming it did not have notice because "the facts were not communicated to the shareholders as a body or to the board of directors." *Id.* at § 786, at 11.⁴

To reach a result contrary to this state law rule, the court of appeals necessarily ignored the interests of ADSB's shareholders. Instead, it is apparent that the court adopted the FDIC's position that the interests of corporate outsiders, in particular the federal government as deposit insurer, should be determinative of the issue whether an agent of an insured depository institution has acted adversely to the institution. This subtle, though dispositive, shift in analysis represents a federal rule of decision that is directly contrary to California law governing the scope of a professional's liability for negligence.

1. By Adopting The FDIC's "Federal Interest" Approach, The Court Of Appeals Fashioned A Novel Federal Rule Of Decision

In its brief to the court of appeals, the FDIC proposed a radical change from state law principles in determining

⁴ See also *J.J. McCaskill Co. v. United States*, 216 U.S. 504, 515 (1910) (refusing to apply adverse interest exception to corporate officers who "own[ed] a large majority of the stock of said corporation, with the entire management and control of the business and affairs," because the "interest of the corporators and the corporation [was] thus shown to be identical, not adverse"); *McKee v. American Casualty Co.*, 316 F.2d 428, 430 (5th Cir. 1963) ("The fact that [a sole shareholder] t[akes] the corporation's money does not insulate it from the knowledge he possess[e]s since there [i]s no adverse interest between [the shareholder] and the corporation wholly owned by him."); 3 Maurice H. Merrill, *Merrill On Notice* § 1273, at 257 (1952) (footnotes omitted) ("[T]he adverse interest rule does not apply to the case where the hostilely concerned officer of a corporation is himself, through ownership or control, substantially the corporation. In such a case, however much the technical interests of the corporation viewed as a legal entity may be opposed to those of the agent, the fact remains that there is substantial identity between them and that the institution is only his pawn.").

the "interests" of an insured depository institution. In particular, the FDIC argued that the interests of the federal government, as deposit insurer, should take precedence over those of the institution's owners in determining whether the knowledge of its agents should be attributed to the institution:

As a separate legal entity, ADSB has rights and liabilities different from those of its shareholders, directors and officers. *Certainly a federally insured thrift institution cannot be identified simply with its shareholders*, in view of the far more substantial economic investment in the institution made by the institution's depositors, as well as the substantial public interest in the thrift arising from the federal government's "full faith and credit" backing of the bank's deposits.

FDIC Opening Brief in C.A. No. 90-55769 at 27-28 (emphasis added) (footnote omitted).⁵

Having apparently accepted the FDIC's argument that the interests of the federal government in ADSB should be elevated over those of its owners, the court of appeals cited two federal cases holding that "conduct aggravating a corporation's insolvency and fraudulently prolonging its life does not benefit the corporation." Pet. App. 12a (citing *Schacht v. Brown*, 711 F.2d 1343 (7th Cir.), cert. denied, 464 U.S. 1002 (1983), and *In re Investors*

⁵ The only authority cited by the FDIC in support of this "federal interest" analysis was *Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp. 901 (D.D.C. 1990). That decision, which did not deal with imputation of knowledge, but rather with whether federal regulators acted properly in placing an S&L into conservatorship, contains the following statement: "While plaintiff ACC [the S&L's parent corporation] invested some \$51 million to purchase Lincoln, the institution's \$1 billion in assets came from depositors with federally insured accounts. Thus, by virtue of its insurance of Lincoln accounts, the federal government's interest in Lincoln is many times that of ACC." 743 F. Supp. at 905. The court of appeals cited *Lincoln* as supporting its refusal to impute Sahni and Day's knowledge to ADSB. Pet. App. 12a.

Funding Corp., 523 F. Supp. 533 (S.D.N.Y. 1980)).⁶ This "deepening insolvency" theory makes sense, however, only if one considers the interests of the corporation to be those of corporate outsiders rather than those of shareholders. Prolonging the life of a corporate entity, even if it results in greater insolvency (*i.e.*, more unpaid debt to outside creditors) may well serve to benefit the shareholders. Although a corporation may be in very weak financial condition, its owners and management still may have hopes of turning the corporation around and avoiding bankruptcy. Whether or not such hopes are realistic, prolonging the corporation's life is intended to benefit the corporation's shareholders. If the efforts do not succeed and bankruptcy follows, it likely will be creditors and other outsiders who will bear the lion's share of the cost.

The court of appeals' departure from state law is graphically demonstrated by the direct conflict between its decision and the Fifth Circuit's decision in *FDIC v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992). The Ninth and Fifth Circuits each purported to apply the adverse interest exception to nearly identical facts, yet reached opposite conclusions. The courts' conflicting holdings are explained entirely by the law they chose to apply.

In *Ernst & Young*, the Fifth Circuit affirmed the grant of summary judgment to an outside auditor who had asserted a defense based on the knowledge of the 100% owner and controlling manager of its client—like ADSB, a failed depository institution. In reaching its decision, the court applied Texas law, holding that the corporation's interests were those of its shareholders at the time of the officer's actions, not the interests of outsiders such as creditors and depositors. See *Ernst & Young*, 967

⁶ It is noteworthy that *Investors Funding* did not cite any authority, state or federal, in support of its "deepening insolvency" theory, and *Schacht* cites only *Investors Funding* in support of the theory.

F.2d at 171 ("Fraud on behalf of a corporation is not the same thing as fraud against it. Fraud against the corporation usually hurts just the corporation; the stockholders are the principal if not only victims But the primary costs of a fraud on the corporation's behalf are borne not by the stockholders but by outsiders to the corporation") (citations and internal quotation marks omitted). Given this legal standard, the Fifth Circuit had no trouble deciding that a 100% shareholder could not act adversely to the corporation he owned and controlled. See 967 F.2d at 171 ("Woods acted on the corporation's behalf because by serving Western [the failed S&L], he served himself, Western's sole owner. As the sole owner, Woods' fraudulent activities on Western's behalf benefitted himself and injured outsiders to Western—i.e. depositors and creditors. Accordingly, under [Texas law], Woods acted on Western's behalf, and, therefore, his knowledge is imputable to Western.").

The Ninth Circuit, in contrast, was able to reach an opposite result only by creating a federal rule of decision in considering the interests of the federal government as deposit insurer to the exclusion of the interests of ADSB's shareholders. By doing so, the Ninth Circuit expanded a professional's liability to third parties for negligence far beyond the bounds permitted by state law.

2. The Court Of Appeals' Federal Rule Of Decision Expands Professional Negligence Liability To Third Parties Beyond The Limits Set By State Law

The court of appeals' decision represents an end-run around settled state law rules that are intended to maintain the negligence liability of a professional to third parties, including particularly creditors of a corporate client, within rational bounds. Of particular relevance in this case, the California Supreme Court has strictly limited the liability of a professional to such parties. First, only the client is permitted to assert a general negligence

claim against the professional. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 767 (Cal. 1992) ("we hold that an auditor's liability for general negligence in the conduct of an audit of its client[s] financial statements is confined to the client i.e., the person who contracts for or engages the audit services").⁷ Second, non-clients may bring a cause of action for the separate tort of negligent misrepresentation, but only if (1) they can prove justifiable reliance on the professional's representations, *id.* at 772 ("By allowing recovery for negligent misrepresentation (as opposed to mere negligence), we emphasize the indispensability of justifiable reliance on the statements contained in the report."), and (2) they belong to a particular class of persons and engaged in a specific type of transaction that the professional intended to influence when it made its representation. *Id.* at 772-773 (adopting "intent to benefit" approach set forth in Section 552 of the *Restatement (Second) of Torts*).⁸

The principal reason identified by the California Supreme Court for adopting the *Restatement* rule was to

⁷ *Bily* addressed professional negligence liability in the context of an accountant that issues an inaccurate audit report, but its holding encompasses all types of professionals. 834 P.2d at 770 ("Accountants are not unique in their position as suppliers of information and evaluations for the use and benefit of others. Other professionals, including attorneys, architects, engineers, title insurers and abstractors, and others also perform that function. And, like auditors, these professionals may also face suits by third parties claiming reliance on information and opinions generated in a professional capacity.").

⁸ Section 552(2) of the *Restatement* provides that a professional's liability for negligent misrepresentation is limited to "loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction."

maintain rational limits on the scope of a professional's liability for mere negligence:

The rule expressed there attempts to define a narrow and circumscribed class of persons to whom or for whom representations are made. *In this way, it recognizes commercial realities by avoiding both unlimited and uncertain liability for economic losses in cases of professional mistake* The Restatement rule thus appears to be a sensible and moderate approach to the potential consequences of imposing unlimited negligence liability which we have identified.

834 P.2d at 769 (emphasis added).⁹

⁹ The vast majority of states have adopted either the *Restatement's* limitations on a professional's liability for negligence or the "near-privy" approach, which is more restrictive of a non-client's standing to sue than the *Restatement* approach. See, e.g., *Colonial Bank of Alabama v. Ridley & Schweigert*, 551 So. 2d 390 (Ala. 1989) (near-privy); *First Florida Bank v. Max Mitchell & Co.*, 558 So. 2d 9 (Fla. 1990) (*Restatement*); *Badische Corp. v. Caylor*, 356 S.E.2d 198 (Ga. 1987) (*Restatement*); *Idaho Bank & Trust Co. v. First Bancorp of Idaho*, 772 P.2d 720 (Idaho 1989) (near-privy); *Essex v. Ryan*, 446 N.E.2d 368 (Ind. Ct. App. 1983) (near-privy); *Pahre v. Auditor of the State of Iowa*, 422 N.W.2d 178 (Iowa 1988) (*Restatement*); *Lindner Fund v. Abney*, 770 S.W.2d 437 (Mo. Ct. App. 1989) (*Restatement*); *Citizens Nat'l Bank of Wisner v. Kennedy and Coe*, 441 N.W.2d 180 (Neb. 1989) (near-privy); *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110 (N.Y. 1985) (near-privy); *Spherex, Inc. v. Alexander Grant & Co.*, 451 A.2d 1308 (N.H. 1982) (*Restatement*); *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609, 616 (N.C. 1988) (*Restatement*); *BankOhio Nat'l Bank v. Schiesswohl*, 515 N.E.2d 997 (Ohio Ct. App. 1986) (*Restatement*); *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991) (*Restatement*); *Haberman v. Public Power Supply System*, 744 P.2d 1032 (Wash. 1987) (*Restatement*), appeal dismissed, 488 U.S. 805 (1988); *First Nat'l Bank of Bluefield v. Crawford*, 386 S.E.2d 310 (W. Va. 1989) (*Restatement*).

Contra Touche Ross v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987) (liability to reasonably foreseeable third

Thus, it is clear that the FDIC and other creditors of ADSB did not have standing in their own right to assert a claim for general negligence against O'Melveny. The FDIC was able to assert such a claim in this case only in its receivership capacity as ADSB's successor-in-interest. Yet the FDIC has sought to avoid state law defenses based on the interests of creditors and other corporate outsiders. Tellingly, the FDIC subsequently has attacked the Fifth Circuit's analysis in *Ernst & Young* by claiming that the court failed to appreciate the FDIC's statutory authority to represent stockholders and depositors of a failed institution, as well as the institution itself. See, e.g., *FDIC v. Shrader & York*, 991 F.2d 216, 223 (5th Cir. 1993) ("The FDIC attempts to distinguish *Ernst & Young*, arguing that, in this case, it is suing on behalf of depositors and other creditors, not just on behalf of the failed institutions."), *petition for cert. filed*, 62 U.S.L.W. 3336 (U.S. Oct. 26, 1993) (No. 93-651). The FDIC's argument is defective because it fails to recognize the critical distinction between (1) the party to whom a cause of action *belongs*, and (2) the parties who will *benefit* from the FDIC's successful assertion of the cause of action.

The federal government, as insurer of ADSB's deposits and hence one of ADSB's largest creditors, would no doubt benefit from a successful professional negligence claim against O'Melveny. The cause of action asserted by the FDIC, however, was not the depositors' or creditors' cause of action. Although the FDIC may have authority to represent a variety of parties and a variety of parties may benefit if the FDIC successfully asserts a claim for professional negligence, if it chooses to assert a cause of action belonging only to the institution itself, the FDIC must satisfy all of the elements of that cause

parties); *Rosenblum Inc. v. Adler*, 461 A.2d 138 (N.J. 1983) (same); *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361 (Wis. 1983) (same).

of action. Likewise, if the FDIC asserts a cause of action on behalf of an institution's creditors or depositors, it must satisfy all of the elements of that cause of action. The Fifth Circuit has recognized and rejected the FDIC's muddled legal analysis. See *Ernst & Young*, 967 F.2d at 171 ("Western cannot claim it should recover from EY for not being rescued by a third party for something that Western was already aware of and chose to ignore. Neither can Western's assignee make the claim. The FDIC in its own capacity or Western's creditors might be able to make this claim, but the FDIC brought this suit only on Western's behalf."); *Shrader & York*, 991 F.2d at 223 ("the FDIC has not pled or offered summary judgment evidence that . . . depositors and other creditors were clients of Shrader & York, and thus able to sue Shrader & York for professional malpractice" under Texas law).

In both this case and *Ernst & Young*, the FDIC chose to assert a cause of action belonging only to the failed institutions, not to the institutions' depositors or creditors. The Fifth Circuit respected state law and required the FDIC to satisfy all of the elements of the cause of action it brought. The Ninth Circuit, however, did not, and the federal rule it created would apply in a class of litigation that subjects professionals to the very type of crushing liability out of proportion to fault that state law precludes.

3. Judicial Respect For State Law Limitations On Professional Negligence Liability Is Particularly Important In Litigation Arising Out Of The S&L Crisis Of The 1980's

The FDIC and the Resolution Trust Corporation have launched the equivalent of a legal blitzkrieg against professionals who provided services to failed depository institutions. In 1990, the Chairman of the FDIC testified before Congress that the "FDIC and RTC currently are conducting investigations in 1,300 institutions and have filed more than 500 lawsuits against former directors,

officers, and other professionals for damages ranging from \$1 million to \$1 billion." *FDIC Considers Suits Against S&L, Bank Officials in 1,300 Institutions*, 55 Banking Rep. (BNA) 97 (July 16, 1990) (internal quotation marks omitted). To carry out this massive task, the FDIC has retained the services of hundreds of law firms and has paid astronomical amounts of legal fees. See *FDIC, RTC Set Fee Cap On Outside Counsel, Say \$615 Million Spent In 1990 Legal Fees*, 56 Banking Rep. (BNA) 314 (Feb. 18, 1991) ("The agency also said the figures include expenses for legal efforts against former executives and professionals—frequently lawyers and accountants—for which the FDIC paid outside counsel about \$80 million and received \$373 million.").

It is perhaps inevitable that this long and concerted effort has produced many lawsuits alleging negligence on the part of outside professionals. Moreover, the damages sought in these cases often are mind-boggling and can threaten the very livelihood of even the largest professional service firms, all because of alleged negligence in a single professional engagement. For example, in *Ernst & Young*, the FDIC sought to recover \$560 million in damages resulting from the failure of a single institution. 967 F.2d at 169. It has been reported that lawsuits pending in 1993 against accounting firms in connection with failed depository institutions allege a total of \$2.3 billion in damages. *Breeden Says Financial Fraud Bill Is A "Step In The Right Direction,"* 60 Banking Rep. (BNA) 262 (Mar. 1, 1993).

It is apparent that the FDIC and other banking agencies are seeking to use the deep pockets of outside professionals as a fund to recoup losses racked up by S&L's in the 1980's. This phenomenon of looking to professionals for a deep pocket from which to recover economic losses was well described by the California Supreme Court in *Bily*:

The auditing CPA has no expertise in or control over the products or services of its clients or their markets; it does not choose the client's executives or make its business decisions; yet, when clients fail financially, the CPA auditor is a prime target in litigation claiming investor and creditor economic losses because it is the only available (and solvent) entity that had any direct contact with the client's business affairs.

834 P.2d at 763.

In many, if not most, of the lawsuits brought by the FDIC, the allegations are similar to those in this case—that outside professionals should have discovered and stopped practices of the institution's owners and managers about which, as in this case, the regulatory authorities had at least as much information as the professional, if not more. Under this type of theory, defenses based on the knowledge and conduct of the institution's owners and management often will be an important aspect of the professional's litigation strategy. Yet the federal rule created by the court of appeals would preclude such defenses and expose professionals to staggering liability based on the interests of third parties to the professional/client relationship.

Thus, the decision below directly implicates the concerns that led state courts to limit the standing of third parties to sue a corporation's outside professionals. One of the potential consequences identified in *Bily* of holding professionals liable to third parties for negligence was imposing liability entirely out of proportion to fault. The court described this problem in language that is peculiarly applicable to cases brought by the FDIC:

[J]udicial endorsement of third party liability negligence suits against auditors limited only by the concept of foreseeability raises the spectre of multi-billion-dollar professional liability that is distinctly out of proportion to: (1) the fault of the auditor (which is necessarily secondary and may be based on complex differences of professional opinion); and

(2) the connection between the auditor's conduct and the third party's injury (which often will be attenuated by unrelated business factors that underlie investment and credit decisions).

As other courts and commentators have noted, such disproportionate liability cannot fairly be justified on moral, ethical, or economic grounds. As one commentator has summarized: "The most persuasive basis for maintaining the limited duty [of auditors] is a proportionality argument. . . . It can be argued as a general proposition in these cases that the wrongdoing of an accountant is slight compared with that of the party who has deceived him (his client) as well as the plaintiff. This rationale for nonliability is similar to the proximate cause grounds on which willful intervening misconduct insulates a 'merely negligent' party from liability."

834 P.2d at 764 (citations omitted) (quoting Rabin, *Tort Recovery for Economic Loss: A Reassessment*, 37 Stan. L. Rev. 1513, 1536-1537 n.74 (1985)).

In sum, the state law limitations on a professional's liability to third parties for negligence were intended to apply and preclude liability disproportionate to fault in just the type of litigation as has arisen out of the S&L crisis. By rejecting O'Melveny's state law defense in order to further the interests of outsiders to the professional/corporate client relationship, the court of appeals adopted a federal rule that violated this fundamental state law determination. Making a policy decision with such far-reaching consequences is the province of Congress, not the federal courts.

CONCLUSION

The judgment of the court of appeals should be reversed.

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